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Central Intelligence Agency

Washington, D.C. 20505

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9 February 1984

MEMORANDUM FOR: Steve Watkins
Canadian Desk
EUR/CAN
Department of State

FROM : [redacted] 25X1
Chief, British Isles, Benelux, Canadian Branch

Attached, as per your request to [redacted] my branch, is an unclassified estimate of Canada's economic prospects. [redacted] 25X1 25X1

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MEMORANDUM

Canada: Continued Recovery in 1984

Summary

The Canadian economy appears to be headed toward a second consecutive year of strong growth with 1984 real GNP expected to be up 4.6 percent. The recovery probably will be more broadly based than in 1983 with all components of final demand contributing to economic expansion by the end of the year. Despite high unemployment, the government is likely to stress economic programs aimed primarily at controlling inflation. Canada probably will have a near-record trade surplus, but a rising services deficit will put the current account near balance.

Canada climbed quickly out of recession in 1983. Third quarter growth reached 8 percent at an annual rate, and GNP probably reached 1981 pre-recession levels by the end of the year. Robust consumer spending -- influenced by temporary government incentives and lower interest rates -- and inventory building contributed to real GNP growth of about 3 percent. The healthy US economy provided Canada with an expanding export market -- especially for lumber and automobiles -- and aided the recovery considerably. Nonetheless, there are still lingering signs of recession. Despite significant gains in durable goods and export markets, demand for nondurables and services remains weak. Moreover, there still has not been much investment in those industries hampered by idle capacity such as mining and machinery.

We expect Canada's recovery will be more broadly based this year. Consumer spending -- bouyed by growth in personal incomes -- should continue to be strong throughout most of the year. A high savings rate, good job growth, and wages that keep pace with inflation will contribute to higher incomes, although an increase in the sales tax scheduled for the fourth quarter of this year will sop up some income growth. Investment in machinery and equipment is just beginning to pick up, and the present decline in nonresidential construction probably will be replaced by a modest upturn by mid-year. The industries likely to exhibit the strongest growth are forestry and transportation equipment. It is unlikely that there will be any significant expansion of the mining, chemicals, food, and energy industries until the latter part of the year.

Canada's unemployment rate has not declined significantly despite the strong recovery. Although two-thirds of the 600,000 jobs lost in the recession were regained in 1983, growth in the labor force has nearly matched employment growth. As a result, unemployment has only dropped marginally, to 11.2 percent in January. Job creation in 1984 will continue to be hampered by idle capacity in several industries, and we expect the unemployment rate to remain well above 10 percent for the rest of the decade.

On 15 February Ottawa will introduce the budget that is likely to take the Liberal government into the election expected sometime in the fall. Finance Minister Lalonde has denied that the document will be a "goodies package" for the electorate. The high government deficit -- expected to be US$23 billion this year -- indeed, leaves virtually no room for any significant changes in current fiscal policy. Lalonde would be reluctant to undermine shaky business confidence in the economy with a large increase in the federal deficit.

Little change is expected in government economic policies. Despite high unemployment, Ottawa, in our view, will continue to stress an anti-inflation program. Consumer price inflation was 5.8 percent in 1983 compared with 10.8 percent the previous year -- a great improvement but still well above that of the United States. Energy and commodity prices should remain stable in 1984, but we expect food prices to begin to exert mild upward pressure on the CPI. We expect consumer prices to rise 5.5 percent in 1984 with only minor improvement the following year. In a further effort to reduce inflation Ottawa probably will announce further wage restraint guidelines in the budget. The "6 and 5" public sector wage* restraint program introduced in 1982 is due to expire this June.

Canada's vast trade and financial ties with the United States force Canada to keep interest rates closely in line with those of the United States. Ottawa is concerned that a rapid rise in interest rates resulting from restrictive monetary policy could cut off an investment recovery in Canada even before it occurs. In addition to interest rates, the Bank of Canada will continue to monitor closely the exchange rate and will attempt to keep the Canadian dollar between US$0.80 and $0.82. Gerald Bouey, Governor of the Bank of Canada, believes a drop in the exchange rate would put too much inflationary pressure on the economy.

Canada's trade position improved during the recession because foreign demand for Canadian raw materials remained steady while imports dropped sharply. In 1982 Canada registered a surplus on the current account for the first time in nine years. The surplus probably fell to around US$1 billion last

*Federal public sector wage increases were held to 6 percent in 1982 and 5 percent in 1983.

year as imports picked up. We expect imports to continue rising as investment activity begins to recover. The trade balance, however, is likely to remain about the same as in 1983 -- US$14 billion surplus -- because of strong export demand from the US recovery. A growing services deficit probably will put the 1984 current account in approximate balance.

Over two-thirds of Canada's trade is with the United States, and Ottawa has recently moved to strengthen trade ties. The Liberal government is studying selected liberalization of trade with the United States; the industries most often discussed for elimination of tariffs are petrochemicals and transportation equipment. In 1983, Canada boosted its trade surplus with the United States, primarily because the US recovery outpaced that of Canada, and the bilateral current account was probably also in surplus. In 1984, Canada is likely to return to the more usual situation vis-a-vis the United States -- a merchandise trade surplus but an overall deficit.

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